



## International Monetary Fund

### **Take-Off or Holding Pattern? Prospects for the Global Economy**

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Conference

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*As Prepared for Delivery*

Good morning. It is a pleasure to address this distinguished gathering this morning. I would like to share my thoughts on the global economy and pending policy challenges. I think it is a good time to take stock. It seems more and more likely that the crisis is behind us, and for that we can all breathe a collective sigh of relief.

But what lies ahead of us? That is less clear. In fact, as a single major challenge gives way to many smaller challenges, the policy responses might be less obvious, and the sense of common purpose might be weakening. There is a lot of uncertainty in the air.

Does this current calm period portend another storm? Well, I think we can limit the risk of new storms by picking the right policies, and by sustaining the successful collaboration across countries. This is what I want to discuss with you today.

I will talk briefly about the outlook for the global economy, and then I will spell out the challenges I see in four key areas—exit strategies, capital flows to emerging markets, the new growth engine, and financial sector reform.

#### **Economic outlook**

We certainly have come a long way over the past year. We all remember the tsunami that was unleashed by the collapse of Lehman Brothers. Uncertainty turned to outright panic, and in the frenzied fallout, economic activity all over the world began to collapse at rates not seen since the Great Depression.

Today, the storm has passed. The worst has been averted. Thanks to a bold and rapid policy response, delivered in an atmosphere of unprecedented policy cooperation, global economic activity is rising again.

And yet, the global economy remains very much in a holding pattern—stable, and getting better, but still highly vulnerable. The major advanced country areas in particular remain fragile, still dependent on policy support. Financial conditions have improved, but are far from normal. Signs show confidence returning, but banking systems in many advanced economies remain undercapitalized, weighed down by leaden legacy assets and, increasingly, non-performing loans. On the household side, weak financial positions and high unemployment will damp down on consumption for some time. And large public deficits add to vulnerabilities.

We see these same global factors at play here in the United Kingdom. There are some positive developments—the overall outlook has improved, and there are indications that job shedding is nearing an end. Still, the recovery may be somewhat subdued, held back by balance sheet adjustment by banks and households. You, the Confederation of British Industry—the representatives of the business community in this country—are well aware of these concerns.

Coming back to the global picture, let me talk about unemployment for a minute. As growth recovers, it will take some time for jobs to follow suit. It's difficult to claim the crisis is over when unemployment is at historic highs, and getting higher still.

So, we stand at a critical juncture. The sustainability of this recovery will depend on the decisions taken by policymakers in the months to come.

The challenges are great. During the crisis, everyone was united by a common purpose. Going forward, this might dissolve. Countries might be pulled in different directions, facing different needs and challenges. Within countries, policymakers will face some delicate balancing acts. The road ahead will be less clear cut. We will need some deft maneuvering, and perhaps some out-of-the-box thinking. We will certainly need continued collaboration.

### **Exit strategies**

Let me address some of these challenges. I'll begin with exit strategies. As the recovery gathers steam, the question of when and how to exit from the accommodative fiscal, monetary, and financial sector policies will top the agenda. Exit too soon, and you kill the recovery. Exit too late, and you sow the seeds for the next crisis. As I said, it will be a delicate balancing act.

Right now, I think it is still too early for a general exit. Exit should instead await a sustained recovery in private demand, as well as entrenched financial stability—a key litmus test. We recommend erring on the side of caution, as exiting too early is costlier than exiting too late.

As the pace of recovery differs among countries, so must exit strategies differ. There's no way to avoid this. But even without this synchronization, countries should strive to cooperate, at least keeping an eye on spillovers. Sometimes this cooperation will be implicit, but sometimes can go further—to avoid, for example, unintended distortions caused by the unwinding of bank guarantees.

Plans for fiscal consolidation should be the top priority, especially in advanced economies. Here, the threats are greater, the politics are more complicated, and the machinery of adjustment is more unwieldy.

So what do we recommend? The immediate challenge for policymakers is to design and communicate strategies for fiscal solvency. Governments should reform fiscal institutions and frameworks so that adjustment can proceed smoothly when the time comes. These plans must start with keeping stimulus measures temporary. They should seek to put entitlement programs on a sustainable

path—some of these reforms can be done in advance without putting the recovery at risk. But they will eventually need to further rationalize expenditure, and—in some cases—raise taxes. But in all of this, we must strive to protect the poor and the unemployed, and pay attention to fairness—so, for example, we might prefer more progressive tax systems.

I see fewer problems with monetary policy, which is more nimble, and better able to adapt to circumstances. Interest rates can be raised before unwinding unconventional measures, and central banks have the necessary tools to re-absorb liquidity. Especially in many advanced economies, monetary policy can afford to stay accommodative for some time, given little sign of inflation on the horizon. But some emerging economies face different challenges, and monetary policy might need to move sooner.

### **Capital flows to emerging markets**

Let me now turn to the second challenge I want to talk about today—capital flows to emerging markets. It really follows directly from the first challenge. Emerging market are ahead of the recovery curve, while interest rates in advanced economies need to stay low for some time. This lack of synchronization is leading to some unintended side effects, one of them being a heavy influx of capital flows to emerging markets. With risk appetite bouncing back, investors are taking advantage of historically low interest rates and gobbling up assets in emerging markets.

So, what should countries do? This presents yet another delicate balancing act. On one hand, we want capital to flow toward emerging markets. We want many emerging markets to shift toward domestic demand, something that will be helped by exchange rate appreciation. But on the other hand, these flows can clearly be destabilizing. They could lead to exchange rate overshooting, asset price bubbles, and financial instability.

I've just come from Asia, and these concerns are very much on the minds of policymakers in the region. So what should countries do? I would first note that this is a pragmatic issue, not a matter of ideology. Countries have a number of policy options in their toolkits. In many countries, appreciation should be the key policy response. Other tools include lower interest rates, reserves accumulation, tighter fiscal policy, and financial sector prudential measures. Capital controls can be part of the package of measures. We are completely open minded. But we should recognize that all tools have their limitations. Again, we should be pragmatic.

### **Growth model**

The third issue I want to discuss pertains to the sources of future growth. I believe the old paradigm is dead, or at least on its last legs. In that model, households in the United States and elsewhere propelled the global economy with their voracious appetite for consumption, soaking up imports from counties that relied heavily on exports to grow. In retrospect, this model had major fault lines. Much of the consumption was financed by an addiction to cheap and easy credit, and this flow was cut off, *cold-turkey* style,

by the financial crisis. And with deleveraging on the agenda, and new financial regulations on the horizon, the tap will not be turned back on any time soon.

Consumer behavior will also change. Problems with household balance sheets and lingering unemployment will push up savings. And then there is the psychological angle. The experience of the crisis may lead consumers to become more cautious, less inclined to take on debt, more likely to save. The crisis, and the sharp rise in unemployment, might remain etched in the collective memory.

So then, if we are to have sustained global growth, somebody else needs to step into the breach. The leading candidates are the surplus countries. And we can see some shifts in the right direction. China and other emerging Asian economies are shifting from exports toward domestic demand, aided by expansionary fiscal policy. But they have some way to go. This shift would be helped by stronger social security systems and higher spending on health and education, as well as reforms to boost access to credit. An appreciation of China's exchange rate, along with some other Asian currencies, will also need to be part of the package.

Remember, everybody gains from this new paradigm. The global economy will have a new engine. And by reducing global imbalances, the world will be a safer place, less prone to crises. It will also be in China's long term interest.

But will we get there? Can emerging markets be persuaded to change a strategy that it has served them well in the past? Will the United States be able to make headway in reducing its fiscal deficit and taming its financial sector as the recovery strengthens? These are the major questions.

### **Financial sector regulation**

The fourth, and final, policy challenge I want to address this morning relates to the financial sector. We all know that the pre-crisis environment encouraged excessive risk taking and leverage. We all know that the financial sector in the advanced economies brought down the whole global economy. Clearly, we must do whatever we can to stop this from happening again. That means we must forge ahead with reforms to make the financial sector a safer, more stable, place. Of course, we must be careful here, as we don't want to kill financial innovation completely.

This is a very lively debate, and there are many good ideas being floated—especially here in the United Kingdom. Let me talk about how the IMF looks at it. First off, since many of the problems took place in the financial *wild west* beyond the regulatory frontier, the perimeter should be widened. To curb excessive risk taking, the amount and quality of capital and liquidity buffers should be increased, especially in good times. Regulators and supervisors should also pay more attention to systemically important institutions, and to their cross-border interactions. This calls for heightened policy coordination.

In addition to better rules, we need better application of rules—and that means beefing up supervision and supervisory capacity. The new regulatory system must do a

better job of avoiding capture and complacency. This is another lesson from the crisis. We also need to address risk management in the financial sector, and break the link between risky behavior and compensation.

In this context, we have been asked by the G-20 to look into financial sector taxes. This is an interesting issue. Can the tax system help reduce excessive risk-taking in the financial sector? Can it be used to further the legitimate goals of fairness and equity in this area? There are a number of ways to think about this, and we will look at it from various angles and consider all proposals. Let me say that the financial sector should contribute to the cost of the rescue and to limiting recourse to public financing in the event of a future crisis. I suggest this for practical reasons because, in my view, there would not be political support in parliaments for a rescue on the scale we have seen during this crisis.

In this whole area, we face yet another delicate balancing act. On one hand, the financial sector is still in bad shape. It will continue to need more capital as asset quality deteriorates. In this environment, imposing tougher standards now could jeopardize the recovery. Do we want to force the patient to exercise before she can even get out of bed? But on the other hand, in an atmosphere of increasing optimism, we see signs of old habits coming back. Risk taking is on the rise, and is manifesting in emerging markets. I've talked about this already.

How, then, do we square this circle? There is no magic bullet, but one possible answer is to reduce regulatory uncertainty. Lay out the future requirements and the timescale for implementation. Right now, regulatory uncertainty is throwing up some perverse incentives. For example, it might be encouraging a risk-taking culture—a *Mardi Gras* effect whereby financial institutions party now in expectation of lean times to come. Clearly, this is dangerous, not least for emerging markets. And we may run out of time—if we wait too long to implement these reforms, it might be too late.

### **Conclusion**

Let me try to tie everything together. The global economy has made remarkable progress over the past year, but as we stand on the cusp of recovery, new and complex challenges are already popping up. How do we deal with these challenges? In my view, there is really only one fundamental answer—to persevere with the spirit of cooperation that has brought us to this point.

We all know the basic facts. During the crisis, perhaps for the first time in history, countries came together to face common challenges with common solutions, and the winner was the global economy. This is the main reason why we avoided catastrophe and why we can see a recovery dawning today.

This unprecedented collaboration was spearheaded by the G-20, putting the responsibility for global economic governance in the hands of more countries than ever before. And here, I want to pay tribute to the United Kingdom, which held the presidency during a critical period. Rising to the challenge, its leadership on the global

stage helped advance the debate in many core areas. We all owe a debt of gratitude to Gordon Brown and his team.

But, as global governance goes, this is only the beginning. We need to keep the flame of cooperation alive. Fortunately, the early signs are favorable. The G-20 leaders pledged to maintain this collaboration, and are working out a plan for the mutual assessment of policies—and the IMF is happy to help with this.

The challenges I have discussed this morning all require cooperation. We need cooperation on exit strategies. We need cooperation on the new growth model. We need cooperation on financial sector regulation.

As we all know, we live in a single, interconnected world where the dividing line between domestic interests and global interests is becoming increasingly blurred. There can be no going back.

Thank you.

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